United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

Signed

75-6134

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

B

NED MILLER and FRANCES MILLER,

Plaintiffs-Appellants

v.

P/S

UNITED STATES OF AMERICA,

Defendant-Appellee

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES

DISTRICT COURT FOR THE EASTERN DISTRICT OF NEW YORK

BRIEF FOR THE APPELLEE

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TABLE OF CONTENTS

CITATIONS

Cases:

Statutes:

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BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUE PRESENTED

Whether the District Court properly determined that the $65,000 distribution to taxpayer from Realty, made free of an obligation to repay and without requirement or expectation that it would be used for Realty's benefit, rather than taxpayer's, was a dividend to taxpayer.

STATEMENT OF THE CASE

Ned Miller (taxpayer) and Frances Miller[1] appeal from a judgment of the United States District Court for the Eastern District of New York (Honorable Mark A. Constantino) in favor of the United States denying their claim for refund of income taxes for 1957. (R. 125a.)[2] The District Court's memorandum opinion and order was filed on November 25, 1975, and is not yet reported. (R. 117a.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

The facts in this case may be summarized as follows:

During the year in issue, 1957, and for several years prior thereto, taxpayer was the president and sole shareholder of two corporations -- the 1680 Coney Island Avenue Realty Corporation (Realty) and Miller Stormguard Corporation (Stormguard). Taxpayer and his wife Frances were the sole directors of both corporations, but did not hold formal board of directors meetings for either corporation. Neither Realty nor Stormguard ever declared a formal dividend. (R. 15a, 16a). One David Rausch was the bookkeeper for both corporations from approximately 1952 until he was fired for the alleged misappropriations of corporate funds in 1962. (R. 18a-21a.)

1/ Frances Miller is a party to this appeal solely by virtue of having filed a joint return with her husband Ned Miller.

2/ "R." references are to the separately bound record appendix. "Tr." references are to the transcript of proceedings at trial which is not reproduced in its entirety in the appendix.

Sometime in 1962, the taxpayer began to suspect Rausch of misappropriating corporate funds. At that time, he engaged the services of Melton Seitman, a certified public accountant, to audit the books of both corporations. (R. 39a.) Seitman discovered that a set of books for Realty had been set up in 1944 upon the formation of the corporation but that no formal books had been kept since that time. There were no books and records for Realty for the years 1955 through 1957.(R. 41a.) Rausch, however, had kept a formal set of books for Stormguard.(R. 42a.) Seitman's audit discovered that,even though Realty had earnings from 1945 on, no tax returns had been filed and no federal income tax had been paid by the corporation.(R. 41a.) Thereupon, taxpayer and Seitman informed the Internal Revenue Service that no returns had been filed and that very few records were available whereupon the Internal Revenue Service assigned an agent to audit what records there were of Realty for the years involved. (Tr. 17, 69.)

By 1955, a large amount of money had accumulated in Stormguard which taxpayer decided to invest.(Tr. 27.) Taxpayer determined to invest in a syndicate named Pittsburgh Properties which was a limited partnership holding an office building in Pittsburgh, Pennsylvania.(Tr. 27-28.) Taxpayer was under the impression that a corporation could not be a limited partner under Pennsylvania law (Tr. 31), and determined to invest the

money himself. Taxpayer considered the Pittsburgh property investment to be a personal investment on his part, and reported the income from that investment on his personal tax return. (Tr. 29, 46-47.)

In order to make this investment, taxpayer caused Stormguard in late 1955 to issue a check to him in the amount of $65,000. (R. 30a.) Taxpayer, in return, executed a demand note in favor of Stormguard for $65,000 bearing interest at two and one-half percent per annum.(R. 30a.) Taxpayer, until 1962, paid Stormguard $1,625 in interest each year on that note. It was taxpayer's intention that when the Pittsburgh Properties investment paid off, he would repay the loan to Stormguard.(Tr. 77-78.) In fact, no amount of principal was ever repaid.(Tr. 76.) When Pittsburgh Properties went into bankruptcy in 1968, taxpayer received only a few hundred dollars which he placed into his personal account (Tr. 46-47.)

Sometime in 1957, Rausch told taxpayer that it was necessary to repay the loan to Stormguard, and that this could be done by replacing it with a loan from Realty. Realty issued a check in the amount of $65,000 to taxpayer in December of 1957 (R. 44a) which taxpayer endorsed to Stormguard. The check was deposited in Stormguard's account and entered on Stormguard's books as a debit to cash receipts and a credit to an exchange account.(R. 45a-46a.) Taxpayer was told by Rausch that the terms of the loan were to continue as before (Tr. 36)--that is, taxpayer owed Realty $65,000, at two and a one-half percent interest, payable on demand--and understood that by endorsing Realty's check over to

Stormguard, he had repaid the loan to him by Stormguard. (R. 32a, 118a.) Rausch also wrote a $65,000 Stormguard check to taxpayer, but that check was never signed and Rausch did not deliver it to taxpayer. (R. 48a-49a.) Rausch, however, did enter that check in the cash disbursements journal of Stormguard. (R. 50a, 119a.)

Upon audit, the Internal Revenue agent determined that the $65,000 check from Realty to Miller (which was endorsed over to Stormguard) was a dividend from Realty to taxpayer which was then used by taxpayer to pay off the 1955 loan. (R. 55a-56a.) Taxpayer paid the tax determined by the agent and instituted this instant suit for the refund of taxes paid.

On the basis of this evidence, the District Court found that taxpayer did not intend to repay the $65,000 which Realty had paid to him (R. 119a), determined the $65,000 check constituted a dividend from Realty to taxpayer, and entered judgment in favor of the United States. Taxpayer appeals.

ARGUMENT

THE DISTRICT COURT PROPERLY DETERMINED THAT THE $65,000 DISTRIBUTION TO TAXPAYER FROM REALTY, MADE FREE OF ANY OBLIGATION TO REPAY AND WITHOUT REQUIREMENT ON EXPECTATION THAT IT WOULD BE USED FOR REALTY'S BENEFIT, RATHER THAN TAXPAYER'S, WAS A DIVIDEND TO TAXPAYER

The sole question on this appeal is whether the District Court erred in holding that the $65,000 distribution from Realty in 1957 constituted a dividend to taxpayer. Section 301(a) and (c) and Section 316(a) of the Internal Revenue Code, Appendix, infra, together provide in effect that any distribution by a corporation to its shareholders out of its earnings and profits constitutes a dividend[3/] and any distribution is deemed to be out of earnings and profits to the extent thereof. It is not disputed that Realty had earnings and profits to the extent of the $65,000 distribution. Such a distribution is includible in the gross income of the shareholder under Section 301(c) of the Code.

It is well established that a dividend has been received by a sole shareholder of a corporation when, as here, he causes the corporation to distribute money or property to him which is subject to his unfettered dominion and when he has no binding obligation to repay (i.e., the distribution is not a bona fide loan). Tollefsen v. Commissioner, 431 F. 2d 511 (C.A. 2, 1970).

3/ As of October 31, 1957 (the end of Realty's fiscal year), Realty's earnings and profits amounted to $93,458.49 after year end adjustments for taxes and penalties. (Tr. 148-149).

In the instant case, the District Court (R. 121a) found that the $65,000 was received by taxpayer without an obligation to repay the amount, and taxpayer does not challenge that finding on appeal as clearly erroneous.[4] Indeed, taxpayer states (Br. 32) that he has never contended that the distribution was a loan from Realty to taxpayer. Rather, taxpayer claims, in one portion of his brief (Br. 16, 34-35), that the transaction constituted an embezzlement by the bookkeeper, Rausch that because of the alleged embezzlement taxpayer did not receive any benefit from the transaction; and that the funds were never subject to his dominion and control.

While we agree with taxpayer that every receipt of money by a shareholder from his corporation which is not a loan is not necessarily a dividend, as a matter of law none of the contentions he raises on brief relieve him of dividend treatment on the distribution. The record fails to support his factual contentions,[5] but even if those facts are taken as true, they would, for the most part, have no bearing on the dividend question.

4/ That finding is amply supported by the evidence. No repayment of any part of the withdrawal, "not even 5 ¢", was ever made (Tr. 76) and taxpayer only intended to repay the amount at some indeterminate time in the future (Tr. 76-77). Moreover, the court found taxpayer's self-serving testimony to be "extremely weak". (R. 121a.)

5/ The contention that Rausch engineered an embezzlement was not pleaded below and is not supported by any evidence. Rausch was a trusted employee in 1957, but was fired in 1962 because taxpayer became suspicious of him. (R. 21a.) Taxpayer's accountant, however, could find no evidence of any wrongdoing on the part of Rausch. (R. 52a-53a.)

Likewise, taxpayer's contention (Br. 24) that he did not receive the money is factually untrue. Rausch drew a check to taxpayer and gave it to him. (R. 30a.) Taxpayer then endorsed it over to Stormguard.

At best, taxpayer's arguments represent a lack of understanding of the principles governing dividend taxation in that they raise circumstances which have no relevance to the question of whether the $65,000 distribution constituted a dividend. The circumstances of taxpayer's 1955 transaction with Stormguard shed no light on the single controlling issue here as to whether taxpayer took the 1957 payment from Realty as an exercise of dominion and subject to his personal control. Nor does the nature of the personal purpose for which taxpayer chose to use the distribution, or which motivated him to cause it to be distributed make any difference. Thus, whether or not the amount in question was intended to be, or was, used to pay off a debt of taxpayer to Stormguard is irrelevant so long as it is clear -- as it is -- that he intended the money to be made available to Stormguard. As the sole shareholder in the latter corporation, his purpose to funnel funds to it from Realty would, if not a loan repayment, constitute a capital contribution by him to Stormguard which would be a personal use of the funds to the same extent as if he had used them to buy a car for himself or to bet on the horses.[6/] Nor does it advance taxpayer's cause to show that he was being ill-used or misled by Rausch with respect to Stormguard's affairs.[7/] So long as taxpayer was aware that he was

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6/ It may be noted that taxpayer has never denied that, had he chosen, he could have deposited the Realty check in his bank account or used it for any purpose he chose, rather than to endorse it over to Rausch to be invested in Stormguard.

7/ If taxpayer had been induced by Rausch to withdraw funds from Realty to invest in a phony uranium mine, it would be a dividend nonetheless (although taxpayer might claim a theft loss under Section 165(c)) (26 U.S.C.).

causing Realty to make a distribution to him and so long as he took it without repayment obligation or obligation to use it for Realty's benefit (i.e., as Realty's agent), it is a dividend.

Taxpayer's insistence that he received no benefit from the distribution because the money did not pass through his hands (Br. 24), is even if true, legally irrelevant. Even if taxpayer had authorized a direct payment to Stormguard by Realty, the transaction would constitute a dividend under familiar principles of constructive receipt, the purpose of the distribution having been to advance his own personal interest as sole shareholder of Stormguard. Sammons v. United States, 433 F. 2d 728, 730 (C.A. 5, 1970). There is no evidence in the record that any corporate business purpose of Realty was served by the payment to taxpayer (or to Stormguard, had the transfer been made directly). Taxpayer has, thus, received all the benefit that is required for dividend taxation.

On brief (p. 34), taxpayer belatedly seeks to cast the 1957 transaction as a corporate investment on the part of Realty. That is, starting with the proposition that the 1955 loan from Stormguard to taxpayer was made so that taxpayer could invest in a Pennsylvania real estate syndicate on behalf of Stormguard since a corporation could not be a limited partner under Pennsylvania law (Br. 12) -- a premise of doubtful supportability -- taxpayer goes on to suggest (Br. 34) that the purpose of the 1957 distribution was to enable Realty to assume Stormguard's investment position as the beneficial party in interest in the Pennsylvania syndicates. In the first place, it is irrelevant whether Stormguard or the taxpayer was the

real party in interest in the Pennsylvania investment. If the real purpose of the 1957 disbursement by Realty was to acquire that investment interest, it is immaterial whether the acquisition was to be from Stormguard or from taxpayer. In either event, whatever else it was, it would not be a dividend.

The short answer, however, is that there is not one scintilla of evidence to support the notion that Realty was seeking to acquire any kind of investment interest from anybody. Indeed, the evidence below is all to the contrary. The evidence is clear that taxpayer, both before and after the 1957 distribution, considered the Pennsylvania investment his own personal investment (Tr. 74); that none of the returns on that investment were ever turned over to either corporation but were deposited into taxpayer's personal account (Tr. 47) and were reported as income on taxpayer's personal returns (R. 34a). In this respect, we do not question taxpayer's legal premise (Br. 33-34) -- that if the funds were transferred to him as an investment agent on behalf of the corporation, the transfer would not be a dividend. Nasser v. United States, 257 F. Supp. 443, 447 (N.D. Cal., 1966).[8/] However, the above-discussed evidence clearly indicates that this was not the purpose or nature of the instant distribution.

There can be no question on this record but that the taxpayer, as the sole shareholder in Realty, caused and received a distribution

8/ Nasser was not, as cited (Br. 33), affirmed on appeal. United States v. Nasser, 301 F. 2d 923 (C.A. 7, 1962), cert. denied, 320 U.S. 923 (1962) was an appeal from a conviction under 18 U.S.C., Sec. 1010 for filing a fraudulent loan application with the Federal Housing Administration.

to him of earnings and profits of the corporation with no obligation to repay and with no limitation on his right to use it for any personal purpose of his own which he might choose. As such, it constituted a dividend under the most basic principles of dividend taxation.

CONCLUSION

For the reasons stated, the decision of the District Court should be affirmed.

Respectfully submitted,

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MARCH 1976.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 22d day of March, 1976, in an envelope, with postage prepaid, properly addressed to him, respectively, as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) In General.--Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * *

(c) Amount Taxable.--In the case of a distribution to which subsection (a) applies--

(1) Amount constituting dividend.--That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount applied against basis.--That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in excess of basis.--

(A) In general.--Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) Distributions out of increase in value accrued before March 1, 1913.--That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

SEC. 316. DIVIDEND DEFINED.

(a) General Rule.--For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders--

* * *